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DE RUEHNR #3264/01 2260529
ZNR UUUUU ZZH
P 140529Z AUG 07
FM AMEMBASSY NAIROBI
TO RUEHC/SECSTATE WASHDC PRIORITY 1692
INFO RUEHXR/RWANDA COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHRC/DEPT OF AGRICULTURE WASHINGTON DC

UNCLAS NAIROBI 003264

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SENSITIVE

DEPT FOR AF/E, AF/EPS, EEB/IFD
TREASURY FOR VIRGINIA BRANDON

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN KE
SUBJECT: Kenya's Economic Growth Strong, But Inflation Rising During Election Campaign

REF: A) NAIROBI 2641 B) NAIROBI 2292

¶1. (SBU) Summary: The Kenyan economy grew 6.3% YOY in the first quarter of 2007, led by strong growth in agriculture, manufacturing, finance, and tourism, and analysts predict 6%-6.7% growth for the year. Lending to the private sector rose 20% in May YOY, reflecting strong growth in consumer spending and rising confidence. Overall inflation in the second quarter rose sharply to 11%, led by food and fuel costs, and expansionary government fiscal policies. Underlying inflation approached or surpassed the Central Bank of Kenya's (CBK) target rate of 5%, but it is unlikely the Ministry of Finance will allow the CBK, in the run-up to the December general election, to raise interest rates high enough to soak up the excess liquidity. Increasing inflation during election campaigns is normal and temporary, but does not seem likely to hinder growth and investment. The GOK should address the rising trend in food prices, which impacts the urban poor most heavily. End Summary.

Economy is Strong in 2007

¶2. (U) In its first-ever quarterly (vs. biannual) report on economic growth, the National Bureau of Statistics (NBS) reported the Kenyan economy grew 6.3% year-on-year (YOY) in the first quarter of 2007 (Q1'07) compared to 4.1% growth in the drought-stricken first quarter of 2006 (Q1'06). NBS reported the following sectoral YOY growth levels for the first quarter:

- Agricultural output grew 12% YOY, led by a 120% increase in tea production, and 43% increase in milk production, both benefiting from renewed rains. Seventy percent of the population works in the agricultural sector, and poverty is highest in rural areas, making agriculture critical to economic growth, poverty alleviation, and more equitable income distribution.

- Manufacturing grew 7.4%, only a little better than the Q1'06 growth of 7.1%. High energy, security and transportation prices continued to sap competitiveness, but the GOK promised to improve roads and cut red tape.

- Hotel and restaurant sector growth accelerated from 2.3% to 5.8% in Q1'07, led by increased hotel bed occupancy that has nearly saturated capacity.

- Financial sector growth rose from 4.3% to 7.3% in Q1'07, led by increased lending to the private sector.

- Electricity and water sector growth rose from 1.4% to 4.9% in Q1'07 thanks to rain-revived hydropower generation.

- The transport and communications sector increased, but more slowly. Transport growth fell from 12.8% in Q1'06 to 5.2% in 2007. Communication growth, led by cell phones, fell sharply from 21.8% in Q1'06 to 9.1% in 2007.

Confidence About Future is High

¶3. (U) Some other growth indicators during the second quarter were a 20% YOY increase in bank lending in May 2007, fuelled by new investments and consumer spending. In the first half of 2007, new car sales, which represent about 10% of vehicle purchases in Kenya, also rose 20%. Panasonic opened a branch office in Nairobi to distribute its products, citing increasing consumer demand for electronics. A Steadman Group survey in March 2007 found 40% of Kenyans said their living standards had improved compared to a year ago, while almost 60% expected their economic status to improve in the next year. Forty six percent of respondents thought investment conditions had improved over the last year, and 58% were confident that conditions for doing business would improve. The business community does not expect the election to lead to any significant changes in Kenya's economic policies or trends.

But Inflation is Rising

¶4. (U) Despite impressive growth performance, cost of living data for the second quarter and the month of July indicate the Kenyan economy is facing inflationary pressures. After falling steadily in the first four months of 2007, overall inflation turned upward May-July. After falling throughout 2006, YOY underlying inflation (which excludes volatile food, energy, and transport-communications) has been rising slowly every month in 2007, reaching a two-year high in July 2007 of 5.5%. The CBK's target for monetary management is

to keep underlying inflation below 5%.

¶5. (U) Overall YOY annual inflation in the second quarter rose steadily, from 5.7% in April, to 11.1% YOY in June 2007, while seasonally adjusted overall inflation stayed between 10% and 11%. Once again, food and drinks led the way, with June 2007 prices up 15% YOY, followed by fuel and power's increase of 8.5% YOY. Underlying annual inflation ranged between 4.9% and 5.2% YOY in the months of the second quarter, but seasonally adjusted underlying inflation rose steadily to 4.6% in June, and 4.7% in July, the highest rate since April 2006.

¶6. (U) After declining in the first quarter, YOY inflation for the Nairobi Lower income group increased sharply in the second quarter, from 3.9% in April, to 12.9% in June 2007. This reflects the higher proportion of income poor families must spend on food and fuel. The Nairobi Middle and Upper income groups saw YOY inflation double in the second quarter, but the increase was slower in the other urban centers. These trends continued in July as well.

As Expected in an Election Year

¶7. (U) Although the GOK claims the major contributing factors to inflationary pressures are rising oil and food prices, its expansionary fiscal policies are also creating inflationary pressures. The FY 2007/08 budget (July-June) increased expenditures by 36.4% to Ksh 693.6 billion (US$9.9 billion), and revenues by 14% to Ksh 428.8 billion (US$6.1 billion), leaving a Ksh 264.8 billion ($3.8 billion) deficit, equivalent to 5.3% of GDP. (See reftel A.) The GOK plans to finance the deficit with privatization receipts, external grants, and domestic borrowing of Ksh 34 billion (US$485.7 million). It is unlikely that all the planned privatizations of state enterprises will be completed in FY2007-08, so the GOK will probably have to borrow more than planned, as it did the previous fiscal year. This expansionary fiscal policy will increase inflationary pressure. However, the GOK got off to a good start in FY2007-08. The CBK reported that GOK domestic debt declined by US$53 million in July 2007. Treasury bonds outstanding fell 1.1% (Ksh 3.2 billion/$US46 million) in July 2007, while other forms of domestic debt decreased 1.3% (Ksh 500 million/$US 7 million).

CBK Reacts, But Not Enough

¶8. (U) In June, the CBK lowered its benchmark rate from 10% to 8.5% to bring it closer to the inter-bank rate of 7%. However, when later data demonstrated the rising inflationary trend, the CBK signaled concern by raising the rate to 8.75% on August 8. The 91-day Treasury Bill rate, repo and inter-bank rates all increased 0.1% from June to July. But the average lending rate of commercial banks declined from 13.4% in May 2007 to 13.1% in June 2007. The rise in CBK interest rate had no effect on the shilling/dollar exchange rate, as energy sector demand for dollars matched dollar inflows.

Growth Expected to Remain Strong, But Could Be Better
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¶9. (U) Government and private sector analysts agree that Kenya's economic growth is robust, with forecasts for 2007 growth ranging from 6.0% to 6.7%. In its quarterly report, the GOK predicted that strong economic growth in trading partners would continue to spur demand for Kenyan goods and services, and that the global economy would also remain supportive. The report also predicted growth in finance, agriculture, manufacturing, tourism, and most other sectors in the following quarters. It admitted that the high cost of production due to high fuel prices and poor infrastructure may inhibit higher rates of growth, but claimed the GOK would fix roads and continue cutting red tape for business. Although the report predicted inflation would decline, the continued rise in food and fuel prices in June and July casts doubt on that forecast.

Comment

¶10. (SBU) The June-July jump to double-digit overall inflation rates, and the adjusted underlying rate's approach to the CBK's 5% warning level are troubling and indicate that monetary policy is too loose. The Ministry of Finance seems unlikely to allow the CBK to raise interest rates high enough to soak up excess liquidity and reduce inflation until after the December general election. Increased government and private spending normally raise inflation during Kenya's election campaigns, but inflation should recede

somewhat in 2008 and does not seem likely to rise to a level that would hinder growth and investment. Unless there's another drought, or the general election campaign turns unexpectedly violent, Kenya seems poised to enjoy growth of about 6.4% in 2007. The GOK should address the factors that keep food prices rising with or without rain, impacting the urban poor most heavily. Poor roads and inefficient markets are the usual culprits, but if demand is outpacing supply, the GOK may also have to consider reducing its protective tariffs on imported food.

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